SMALL BUSINESS ADVOCACY REPORT NO. 13

TARGETTING EMPLOYEE SHARE OWNERSHIP PLANS TO SMALL BUSINESS

September, 1986

MINISTRY OF INDUSTRY, TRADE AND TECHNOLOGY
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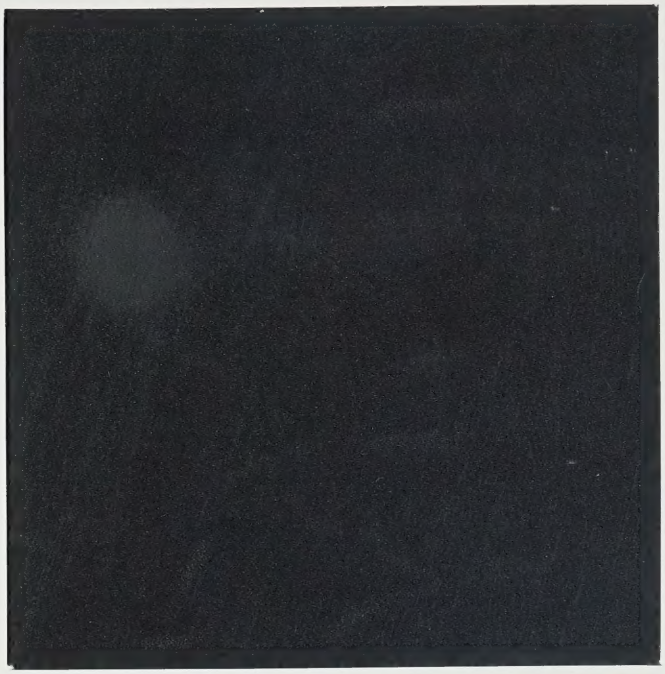

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TARGETTING EMPLOYEE SHARE OWNERSHIP PLANS TO SMALL BUSINESS

September, 1986

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EXECUTIVE SUMMARY

The Employee Share Ownership Plan proposal is a commendable initiative to promote a stronger cooperative relationship between employees and their firms. At the same time, it offers an opportunity for firms to raise equity capital. The latter factor is especially important to small companies traditionally hampered in their expansion by the difficulty of raising equity through conventional markets. For this reason Small Business Advocacy has analyzed the plan's attractiveness to small business and developed recommendations on how the plan's optimum use by the small business community may be encouraged.

A high proportion of Ontario companies are small firms. Because of the unique circumstances of small companies, a special sub-set of criteria within Employee Share Ownership Plan is suggested to better address the needs of the small business community. These recommendations address the constrained financial resources of smaller firms along with their higher risks.

Briefly, the recommendations are:

- an enriched incentive for small firms and their employees;
- a higher level of assistance to small firms for implementation costs;
- a higher level of share ownership permitted in small firms;

EXECUTIVE SUMMARY

The Employee Share Ownership Plan proposal is a comprehensive initiative to promote a stronger cooperative relationship between employees and their firms. At the same time, it offers an opportunity for firms to raise equity capital. The latter factor is especially important to small companies traditionally hampered in their expansion by the difficulty of raising equity through conventional channels. For this reason Small Business Advocacy has analyzed the plan's attractiveness to small business and developed recommendations so that the plan's usefulness to the small business community may be enhanced.

A high proportion of Ontario companies are small firms. Because of the unique circumstances of small companies, a special subset of incentives within employee share ownership plans is suggested to better address the needs of the small business community. These recommendations address the constraints/financial resources of smaller firms along with their higher risks.

Briefly, the recommendations are:

. an expanded incentive for small firms and their employees;

. a higher level of assistance to small firms for implementation costs;

. a higher level of share ownership permitted in small firms;

- in general, that all companies be required to provide employees with information regarding the risk component of the investment and the limited secondary market for shares; and

- that the program be reviewed bi-annually to ensure current applicability of criteria used.

TARGETTING ESOP TO SMALL BUSINESS

The proposed incentive plan to encourage employee share ownership of Ontario firms deserves support. A financial commitment by employees in their firm often results in improved management-employee relations and greater productivity. It also represents a source of equity financing for the company.

For small companies, equity capital for business expansion is often difficult to find by virtue of a company's unproven status. The ESOP proposal, although not primarily designed for equity creation, does nonetheless represent an opportunity area for raising investment capital. It appears, however, that the proposed plan is not designed to address the circumstances of very small firms. Since about 98% of Ontario companies have less than 100 employees, unless special provisions are adopted few small businesses in Ontario will choose to participate.

The following is an analysis of the plan's weaknesses as applied to small businesses, along with recommendations to tier the program to small firms. These recommendations are offered in order to provide a special sub-set of conditions attractive to and feasible for small businesses within the overall plan structure. The specific recommendations have been made in relation to the proposed criteria being retained for larger companies.

1. <u>Size of Incentive</u>

A maximum tax credit of $300 is not an adequate incentive to encourage an employee to place an investment of $2,000 in a small company. The company has limited assets,

likely does not have a market for its shares and, if young, has an unproven track record. Yet the company may well have strong growth potential. To accommodate the risk factor, we suggest a greater incentive for small companies.

2. Amount of Equity

The ESOP proposal would include companies with revenues of up to $50 million. Such companies might employ as many as 600 employees. Where a firm of this size adopted an ESOP and if, for example, 30% of employees opted in, the equity raised under the current proposal would be 180 x $2,000 ie. $360,000. This is a significant placement and warrants the cost of both installing the scheme and incurring on-going administration costs.

By comparison, a 30% take-up of a firm of 100 employees raises only $60,000. The amount may be inadequate to warrant installing the plan because of initiation and on-going costs (eg. trustee services, auditing, periodic share valuation, buy-back procedures).

The government should consider raising the amount of equity that can be raised under the plan to make it more attractive to the small firm.

Recommendation 1:

To help encourage take-up of the plan by smaller companies, the following options are proposed:

For companies having less than 100 employees (currently corresponding to about $10.0 million in annual revenues and assets)

Option 1

. **a tax credit of 15% of the share price to a maximum of $600 per employee per year from Ontario tax payable i.e. a share purchase of $4,000.**

Option 2

. **a tax credit of 25% of the share price for companies operating in southern Ontario, 30% of the share price for companies operating in northern Ontario, to a maximum of $500 and $600 respectively i.e. a share purchase of $2,000.**

Both options provide a greater incentive to small companies and their employees. Option 1 provides for a higher equity placement which may be crucial in the decision to implement the plan. Option 2 recognizes the risk factor involved in small company investments.

3. Plan Implementation Costs

The concept of financially assisting with the costs of establishing a plan is a strong point of the proposed scheme. Such a measure will go a long way to encourage program implementation. However, we feel that the proposed incentive of one-third of the cost of establishing the plan to a maximum of $10,000 is more appropriate for larger firms, which are better able to absorb the costs through larger equity placements. Smaller firms will raise much less equity and can access the necessary legal and financial assistance only at considerable cost. We therefore feel that the proportionately greater burden on small businesses should be recognized by a higher level of incentive.

Recommendation 2

To address the regressivity of implementation costs, we recommend that:

For companies having less than 100 employees (or corresponding annual revenues and assets), a grant from the Government be provided equal to the lesser of $10,000 or one half of the eligible plan set-up costs.

4. Ownership Limit

We support the principle of permitting full participation of employees and accordingly understand why the proposal limits an individual's percentage of ownership. However, the 5% limit is overly restrictive for smaller companies. The reasons include:

(a) A 5% limit on very small firms could result in an incomplete share purchase.

(b) Employee share ownership is often used by a firm to allow for succession planning or for structuring an employee buy-out. Under the proposed ownership criterion, a small firm wishing to establish an ESOP for these purposes would not qualify for the grant, nor its employees for the tax incentives.

(c) Since there appear to be opportunities to link the federal registered retirement savings plan with the ESOP proposal, greater compatibility between ownership criterion is desirable. Although there are special provisions for investments under $25,000, the general RRSP limit on equity is 10% and it is suggested that the ESOP adopt the same criterion.

<u>A 10% individual limit should be adopted for employees of small companies.</u>

Recommendation 3

Because of the onerous constraints of the 5% limit on ownership of small companies, it is recommended that:

For companies having less than 100 employees (or corresponding annual revenues and assets), a significant shareholder be defined as a person who holds at least 10% of the shares of the corporation's capital share.

5. <u>Valuation and Liquidity Issues</u>

We agree with the initial two-year restriction on the sale of shares, since this provides the company with a certain degree of security. It is important to emphasize to the employees as share purchasers that the investment should be considered as a long-term commitment. In a private company, there may not be a secondary market for the shares, and conditions for buy-back by the firm should be clearly understood by the employees.

While it is not desirable for the government to specify and regulate all details of the agreement between a company and its employee shareholders, it is wise to provide guidelines for the procedure, itemizing certain requirements for information disclosure to the prospective buyer. In this way the government protects itself against being held responsible for promoting unreasonable expectations.

The type of issues which might be required to be explained are:

- the method and periodicity of share valuation;
- the quantities that will be made available with each new share issue;
- methods of payment;
- buy-back and transfer arrangements on death or retirement from the firm; and
- where applicable, the lack of a secondary market.

The issues of valuation and liquidity of private company share are technically complex. Small Business Advocacy plans to commission a study which would address these issues in relation to the opportunities for RRSP investments in small business. The study results regarding valuation and liquidity may prove helpful in presenting the ESOP option to companies and employees. Continued cooperation between ministries on this important topic will ensure optimum assistance for the small business community.

Recommendation 4

If ESOP is to be successful, the plan must carefully balance the need for companies to raise capital with investor protection. Problems, such as violations of securities regulations, will only serve to undermine the long-term appeal of the program.

It is therefore recommended that:

All companies establishing ESOPs be required to indicate clearly on all applications, brochures and publications the risk component of the investment and the limited secondary market for the shares.

Recommendation 5:

The current proposal's criteria are related to 1986 costs. To ensure continuing relevance of the program in future years, it is recommended that:

The program be reviewed bi-annually to ensure current applicability of criteria.

Conclusion

Since employee share ownership is an important mechanism for encouraging long-term employee commitment to the fiscal health of the company as well as representing an opportunity to secure equity for expansion purposes, we are eager to see the optimum use of the plan.

The recommendations contained here have been formulated to stimulate interest among the many smaller companies of this province and encourage active take-up of the program by the small business community.

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<u>Anticipated Additional Costs for Small Business Tier</u>

- Implementation grant

  Assume additional take-up of 300 small firms at average cost of $6,000 grant

  = $1.8 million

- Employee incentive

  Assume 300 firms with:
  -average 40 participants
  -average investment $1,500
  -average tax credit $225

  = $2.7 million

  $4.5 million

- Equity Raised — $18.0 million

- Ratio of equity raised to cost — 4 :1